Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Campbell	Analyst:	Gloria McConnell	Bill Number:	AB 2588
Related Bills:	See Legislative History	Telephone:	845-4336	Introduced Date:	02/25/00
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Personal Income & Bank and Corporation Tax Rates/Percentage of Federal Tax

SUMMARY

This bill would change the method of computing the California personal income tax (PIT) and bank and corporation tax (BCT) for taxpayers who do not have any income generated in another state or country. For these taxpayers, the tax would be a yet-to-be-determined percentage of the taxpayer's federal tax liability. For the PIT taxpayers the yet-to-be-determined percentage of the taxpayer's federal tax liability would be designated for each specified income bracket. The California tax would then be reduced by any credits allowed under California's PIT and BCT law.

EFFECTIVE DATE

This bill, as a tax levy, would be effective immediately and operative for tax years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 343 (1996/95) proposed that for calendar year 1995 only, individuals who were not engaged in business, farm or rental activities or did not have items treated differently for federal or state tax purposes would compute their California income tax based on a percentage of their federal taxable income, but only if no federal income tax law changes were enacted for tax year 1995. This bill was held without being heard in its first policy committee, Senate Revenue and Taxation Committee.

AB 987 (1999/00) would have declared the Legislature's intent to simplify the Personal Income Tax (PIT) and Bank and Corporation Tax (B&CT) laws. AB 987 was similar to this bill. It would have changed the method for calculating the personal income tax for taxpayers that do not have any income that is taxed by another state or country. The PIT for these taxpayers would be a yet-to-be-determined percentage of the taxpayer's federal tax liability, prior to the application of any federal tax credits for the same taxable year, reduced by any credits allowed under California's PIT law. This bill did not pass its first policy committee, Assembly Revenue and Taxation Committee.

Previous ballot initiatives that would have enacted this tax method have been rejected by the voters.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Alan Hunter for GHG	4/4/00
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PROGRAM HISTORY/BACKGROUND

Federal legislation typically is not enacted until late in the year; however, the changes may be applicable beginning in that year. Typically, the federal legislative year ends after the California legislative year. So, at the time California law is enacted for a given year, federal laws for that same year may still be undecided. Using federal law to compute California taxes before California has had an opportunity to review and enact it is considered “prospective conformity.” It has been Legislative Counsel’s opinion that prospective conformity would be an unconstitutional delegation of state legislative powers to the federal government. This tax method frequently is referred to as “coupling.”

SPECIFIC FINDINGS

California’s PIT and BCT laws specifying items of income and deduction includible in the taxable base are largely patterned upon federal law.

- To compute California PIT tax, taxpayers begin by copying their federal adjusted gross income (AGI) to their California income tax return. However, because state tax law combines unique state provisions with selected federal provisions that sometimes are modified, adjustments to federal AGI and other federal numbers are required for state purposes. The PIT tax rate ranges from 1% to 9.3%, whereas the federal individual income tax rate ranges from 15% to 39.6%. California and federal laws also impose an alternative minimum tax but again with differences, including the rate which generally is 7% for California and at a rate of up to 28% for federal purposes. Married couples in California are taxed at the same rate as though they are two single individuals with the same income, whereas under federal law they are taxed at a higher rate than if they were two single individuals (referred to as the “marriage penalty"). Nonresidents and part-year residents are taxed only on income from California sources, but the rate of tax is determined by referencing income from all sources and then using a ratio to eliminate the benefit of the graduated tax rate structure.

  To compute California corporate tax, taxpayers begin by copying their federal taxable income to their California franchise tax return, with state adjustments. If the taxpayer has no federal filing requirement or maintains separate records for state purposes, an alternative method for computing state taxes is available. California has not conformed to most of the 1998 or 1999 federal corporate tax law changes.

  When a corporate taxpayer derives income from sources both in and outside California, the income attributable to California must be determined, which involves complex rules for apportioning business income and allocation of nonbusiness income. In general, entities subject to the B&CTL are taxed at 8.84%, S Corporations at 1.5%, banks/financials at 10.84% and financial S corporations at 3.5%. Because banks/financials are not subject to all taxes paid by other corporate taxpayers, they pay a higher tax rate than other corporate taxpayers. In most cases, B&CT payers are required to pay at least a minimum franchise tax, which is currently $800, for the privilege of doing business in California. The corporate alternative minimum tax rate is 6.65%, whereas the federal rate is 20%. Unrelated business income of organizations that are tax exempt is also subject to tax. California corporate net income included in the measure of the franchise tax includes interest earned on federal, state and local bonds.

This is permissible since the franchise tax is not a direct income tax, which would exclude these federal income sources, but rather is a tax on the privilege of doing business in the state as measured by income.

The California corporate franchise tax can be reduced based on a variety of allowable credits (but not below the $800 minimum amount). In addition, specific additional deductions and credits are allowed businesses in enterprise zones and targeted areas and to specified businesses such as manufacturers. Special rules are provided for the taxation of multi-jurisdictional corporations and banks. Special rules also apply to credit unions, certain mines, entities that pass their income/expenses/losses/deductions/credits to their partners/shareholders, and other special entities (real estate investment trusts [REITs], real estate mortgage investment conduits [REMICs], regulated investment companies [RICs], limited and limited liability partnerships [LLPs], limited liability companies [LLCs] and financial asset securitization investment trusts [FASITs]).

Other areas that reflect significant differences between federal and state law that would be affected by this bill are:

- Treatment of depreciation, net operating losses (NOLs), including disaster NOLs, and determining basis in computing gains and losses;
- Exempt interest income and lottery winnings taxable under federal law but not state law;
- Social Security, worker's compensation or unemployment benefits taxable under federal law and exempt under state law;
- Treatment of personal and dependent exemptions as deductions under federal law and credits under state law;
- Treatment of married couples as previously discussed;
- Treatment of state income taxes paid;
- Special state tax deductions intended to provide economic incentives and support social policies.

This bill would change the method of computing California's PIT and B&CT for taxpayers that do not have income generated in another state or country. For these taxpayers, the tax would be a yet-to-be-determined percentage of the taxpayer's federal tax liability. For the PIT taxpayers the yet-to-be-determined percentage of the taxpayer's federal tax liability would be designated for each specified income bracket. The California tax would be reduced by any credits allowed under California's PIT and B&CT law. Taxpayers with income generated outside California would continue to be subject to the existing PIT and B&CT laws.

Policy Considerations

- Automatic conformity to federal laws enacted after California’s Legislature recesses may be an unconstitutional delegation to Congress of California’s legislative powers.

- A “marriage penalty” would be created because California would be adopting the federal married-couple standard deduction, which is instrumental in creating the federal “marriage penalty.”

- Certain special state deductions and exclusions that target specific taxpayer groups or encourage specific taxpayer behavior (i.e., disaster NOL deduction, crime hot-line reward exclusion and rideshare exclusion) would be eliminated.

- For taxpayers who itemize their deductions, federal law allows a deduction for state income taxes paid. Under this proposal, this deduction, which is not available under current law, would likewise be allowed for state tax purposes and may not be appropriate.

- This bill would allow individual taxpayers to benefit from both the federal personal exemption deduction and the state personal exemption credit. In using the federal tax liability as a basis for calculating this proposed state income tax, an individual indirectly receives benefit of the federal personal exemption deduction. In addition, by allowing taxpayers to use state exemption credits to reduce their computed tax liability, this bill allows individuals to directly benefit from the state personal exemption credit.

- California PIT currently is computed by making the following adjustments to federal adjusted gross income, which would not be made under this bill: state tax refunds; unemployment compensation; social security benefits; railroad retirement benefits; capital gains and losses; IRA distributions; pension and annuities; interest on federal securities ; and moving expense reimbursements.

- For S corporations and other special entities (REMICs, REITs, RICs, limited and limited liability partnerships, LLCs, and FASITs), the entity is not taxable at the federal level. Therefore, these corporations with income generated solely within California would not be subjected to California tax under this proposed method of taxation. Additionally, for corporations and special entities with income generated solely from California, the minimum franchise tax or special entity tax (equal to the minimum franchise tax) would be eliminated, yet for those corporations and other special entities subject to California tax with income generated outside California, the minimum franchise tax or special entity tax would continue to be imposed.

- Under the Constitution of the United States and federal law, interest on United States government-issued bonds, though taxable under federal law, generally cannot be taxed for state purposes if interest on state obligations are not also taxed. This bill would violate those constitutional and statutory provisions.

Additionally, this bill would be in conflict with the California Constitution. To the extent that interest on state or local government-issued bonds is constitutionally exempt from state taxes, but is taxed under federal law because of specialized private business use and arbitrage provisions that are not applicable under California law, such interest would be includible in the taxpayer's income to arrive at the percentage of federal tax for state tax purposes.

- This bill would treat corporations with income exclusively from sources in California differently than corporations subject to California tax with income from sources outside of this state and would likely be subject to challenge as an unconstitutional discrimination against corporations engaged in interstate commerce.
- Lottery winnings are taxable under federal law, but exempt for state tax purposes. This bill would be in conflict with that California law that allows for the exemption, as such winnings would be included to arrive at the percentage of federal tax for state tax purposes.
- California's current PIT filing requirement thresholds would not apply to taxpayers using the coupling method. Instead, the federal filing requirement thresholds would be used, and as such, any California residents with California source income who are required to file a federal tax return would be required to file a California tax return.
- California's tax law is more progressive than federal law, with higher filing thresholds. This bill could subject low-income Californians to income tax who currently do not pay California tax or have a filing requirement. This concern may be addressed by the as-yet-undetermined filing thresholds in the bill.
- The income brackets used in this bill for the PIT are the same brackets used under current law to impose the PIT for tax year 1998. However, under current law, "income" for income tax brackets is California taxable income (federal AGI with California adjustments). This bill is unclear how taxpayer would compute their income for purposes of the income brackets, e.g., federal taxable income or federal adjusted gross income.

FTB staff in March 1991 prepared a report that discusses the impact of coupling the state PIT tax to federal tax. This report is available on request.

Implementation Considerations

Considering the magnitude of the policy issues, this analysis assumes the bill will experience significant amendments as it moves through the legislative process. Therefore, a detailed implementation plan has not been developed, and the full impact on the department's programs and operations has not been determined. However, it is known that to administer this bill would require significant planning and restructuring to maintain efficiencies without jeopardizing or disrupting collection of tax revenue.

Under this bill, the FTB would have to continue its current computer program and business processing structure to accommodate those with income generated in other states or countries. This may cause noncompliance and confusion given that there would be two tax methods (and tax tables) in existence.

For 1998, approximately 600,000 PIT returns were filed reporting income from sources outside California, and 13 million PIT returns were filed reporting income from California sources only. Data for 1998 are not available for corporate taxpayers. However, for 1997, approximately 400,000 B&CT returns were filed reporting income from California sources only and 40,000 B&CT returns were filed reporting income from sources outside California, which are the more complex tax returns.

Historically, California uses “sourcing” rules and the taxpayer’s residency or domicile to determine how certain income is taxed. For example, dividends and interest are sourced to the place of an individual’s residency or a corporate taxpayer’s state of domicile and subject to tax accordingly. This bill uses the term “income generated” to determine which tax method to which a taxpayer would be subjected. Hence, for the following kinds of income, it is unclear whether it would be “income generated” inside or outside California:

- Dividends paid by a California company or mutual funds that has multistate activities.
- Salary paid by a multistate corporation or California company where the taxpayer or other employees travel outside California for the company.
- Interest received from banks headquartered inside California, but with business activities conducted outside California.
- Distributive shares of income from pass-through entities that have multistate activities.

The federal individual and corporate tax returns apply tax credits against “tax” to arrive at “total tax,” which includes the alternative minimum tax. This bill indicates the California tax would be a percentage of the taxpayer’s “federal tax liability.” This analysis assumes that the percentage is of “total tax,” which includes AMT, but this should be clarified in the bill.

The full impact of this bill will be determined as the bill moves through the legislative process. Staff will work with the author on this bill as the bill is developed.

FISCAL IMPACT

Departmental Costs

FTB does not yet know the departmental costs that would be associated with this bill. However, it is known that some of the issues that will need to be resolved by staff in developing the costs will include:

- How many new taxpayers would be filing under this proposed coupling structure;
- How many additional tax forms would need to be distributed;
- Whether electronic and telefiling could be implemented for the first year filing under this proposed coupling structure (tax year 2000 returns, which may be filed as early as January 1, 2001);
- The extent of taxpayer confusion resulting in questions and errors, e.g., how many taxpayers would question the new form and/or the two filing methods (assuming FTB were to maintain the current access rate for its telephone service center); and
- How many taxpayers would correspond or make errors because of the new form, using the wrong booklet instructions and therefore using wrong method/tax table?

Tax Revenue Estimate

The revenue estimate is unknown and cannot be determined until the percentage of federal tax is determined.

BOARD POSITION

Pending.